



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-150760-13]

RIN 1545-BM05

Definition of Real Estate Investment Trust Real Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the definition of real property for purposes of the real estate investment trust provisions of the Internal Revenue Code (Code). These proposed regulations provide guidance to real estate investment trusts and their shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for September 18, 2014 must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-150760-13), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-150760-13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-150760-13). The public hearing will be held in

the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Andrea Hoffenson, (202) 317-6842, or Julianne Allen, (202) 317-6945; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to real estate investment trusts (REITs). Section 856 of the Code defines a REIT by setting forth various requirements. One of the requirements for a taxpayer to qualify as a REIT is that at the close of each quarter of the taxable year at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and government securities. See section 856(c)(4). Section 856(c)(5)(B) defines real estate assets to include real property and interests in real property. Section 856(c)(5)(C) indicates that real property means “land or improvements thereon.” Section 1.856-3(d) of the Income Tax Regulations, promulgated in 1962, defines real property for purposes of the regulations under sections 856 through 859 as--

land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term “real property” includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as used in section 856 and the regulations thereunder. The term includes, for example, the wiring

in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Section 1.856-3(d).

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties,¹ mobile home units permanently installed in a planned community,² air rights over real property,³ interests in mortgage loans secured by total energy systems,⁴ and mortgage loans secured by microwave transmission property,⁵ and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets. Because letter rulings are limited to their particular facts and may not be relied upon by

¹ Rev. Rul. 69-94 (1969-1 CB 189), (see §601.601(d)(2)(ii)(b) of this chapter).

² Rev. Rul. 71-220 (1971-1 CB 210), (see §601.601(d)(2)(ii)(b) of this chapter).

³ Rev. Rul. 71-286 (1971-2 CB 263), (see §601.601(d)(2)(ii)(b) of this chapter).

⁴ Rev. Rul. 73-425 (1973-2 CB 222), (see §601.601(d)(2)(ii)(b) of this chapter).

⁵ Rev. Rul. 75-424 (1975-2 CB 269), (see §601.601(d)(2)(ii)(b) of this chapter).

taxpayers other than the taxpayer that received the ruling, see section 6110(k)(3), letter rulings are not a substitute for published guidance. The IRS and the Treasury Department recognize the need to provide additional published guidance on the definition of real property under sections 856 through 859. This document proposes regulations that define real property for purposes of sections 856 through 859 by providing a framework to analyze the types of assets in which REITs seek to invest. These proposed regulations provide neither explicit nor implicit guidance regarding whether various types of income are described in section 856(c)(3).⁶

Explanation of Provisions

Consistent with section 856, the existing regulations, and published guidance interpreting those regulations, these proposed regulations define real property to include land, inherently permanent structures, and structural components. In determining whether an item is land, an inherently permanent structure, or a structural component, these proposed regulations first test whether the item is a distinct asset, which is the unit of property to which the definitions in these proposed regulations apply.

In addition, these proposed regulations identify certain types of intangible assets that are real property or interests in real property for purposes of sections 856 through 859. These proposed regulations include examples to illustrate the application of the principles of these proposed regulations to determine whether certain distinct assets are real property for purposes of sections 856 through 859.

Distinct asset

⁶ One of the requirements for qualifying as a REIT is that a sufficiently large fraction of an entity's gross income be derived from certain specified types of income (which include "rents from real property" and "interest on obligations secured by mortgages on real property or on interests in real property"). Section 856(c)(3).

These proposed regulations provide that each distinct asset is tested individually to determine whether the distinct asset is real or personal property. Items that are specifically listed in these proposed regulations as types of buildings and other inherently permanent structures are distinct assets. Assets and systems specifically listed in these proposed regulations as types of structural components also are treated as distinct assets. Other distinct assets are identified using the factors provided by these proposed regulations. All listed factors must be considered, and no one factor is determinative.

Land

These proposed regulations define land to include not only a parcel of ground, but the air and water space directly above the parcel. Therefore, water space directly above the seabed is land, even though the water itself flows over the seabed and does not remain in place. Land includes crops and other natural products of land until the crops or other natural products are detached or removed from the land.

Inherently permanent structures

Inherently permanent structures and their structural components are real property for purposes of sections 856 through 859. These proposed regulations clarify that inherently permanent structures are structures, including buildings, that have a passive function. Therefore, if a distinct asset has an active function, such as producing goods, the distinct asset is not an inherently permanent structure under these proposed regulations. In addition to serving a passive function, a distinct asset must be inherently permanent to be an inherently permanent structure. For this purpose, permanence may be established not only by the method by which the structure is affixed but also by the weight of the structure alone.

These proposed regulations supplement the definition of inherently permanent structure by providing a safe harbor list of distinct assets that are buildings, as well as a list of distinct assets that are other inherently permanent structures. If a distinct asset is on one of these lists, either as a building or as an inherently permanent structure, the distinct asset is real property for purposes of sections 856 through 859, and a facts and circumstances analysis is not necessary. If a distinct asset is not listed as either a building or an inherently permanent structure, these proposed regulations provide facts and circumstances that must be considered in determining whether the distinct asset is either a building or other inherently permanent structure. All listed factors must be considered, and no one factor is determinative.

One distinct asset that these proposed regulations list as an inherently permanent structure is an outdoor advertising display subject to an election to be treated as real property under section 1033(g)(3). Section 1033(g)(3) provides taxpayers with an election to treat certain outdoor advertising displays⁷ as real property for purposes of Chapter 1 of the Code.

Structural components

These proposed regulations define a structural component as a distinct asset that is a constituent part of and integrated into an inherently permanent structure that serves the inherently permanent structure in its passive function and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. An entire system is analyzed as a single distinct asset and, therefore, as a single structural component, if the

⁷ Section 1.1033(g)-1(b)(3) defines outdoor advertising display for purposes of the section 1033 election as “a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently attached to a building or other inherently permanent structure.”

components of the system work together to serve the inherently permanent structure with a utility-like function, such as systems that provide a building with electricity, heat, or water.⁸ For a structural component to be real property under sections 856 through 859, the taxpayer's interest in the structural component must be held by the taxpayer together with the taxpayer's interest in the inherently permanent structure to which the structural component is functionally related. Additionally, if a distinct asset that is a structural component is customized in connection with the provision of rentable space in an inherently permanent structure, the customization of that distinct asset does not cause it to fail to be a structural component.

Under these proposed regulations, an asset or system that is treated as a distinct asset is a structural component, and thus real property for purposes of sections 856 through 859, if the asset or system is included on the safe harbor list of assets that are structural components. If an asset or system that is treated as a distinct asset is not specifically listed as a structural component, these proposed regulations provide a list of facts and circumstances that must be considered in determining whether the distinct asset or system qualifies as a structural component. No one factor is determinative.

These proposed regulations do not retain the phrase "assets accessory to the operation of a business," which the existing regulations use to describe an asset with an active function that is not real property for purposes of the regulations under sections 856 through 859. The IRS and the Treasury Department believe that the phrase "assets accessory to the operation of a

⁸ See Rev. Rul. 73-425 (1973-2 CB 222), (see §601.601(d)(2)(ii)(b) of this chapter) (holding that a total energy system that provides a building with electricity, steam or hot water, and refrigeration may be a structural component of that building). The IRS and the Treasury Department are considering guidance to address the treatment of any income earned when a system that provides energy to an inherently permanent structure held by the REIT also transfers excess energy to a utility company.

business” has created uncertainty because the existing regulations are unclear whether certain assets that are permanent structures or components thereof nevertheless fail to be real property because they are used in the operation of a business. Instead, these proposed regulations adopt an approach that considers whether the distinct asset in question either serves a passive function common to real property or serves the inherently permanent structure to which it is constituent in that structure’s passive function. On the other hand, if an asset has an active function, such as a distinct asset that produces, manufactures, or creates a product, then the asset is not real property unless the asset is a structural component that serves a utility-like function with respect to the inherently permanent structure of which it is a constituent part. Similarly, if an asset produces or contributes to the production of income other than consideration for the use or occupancy of space, then that asset is not real property. Thus, items that were assets accessory to the operation of a business under the existing regulations will continue to be excluded from the definition of real property for purposes of sections 856 through 859 either because they are not inherently permanent or because they serve an active function. These distinct assets include, for example, machinery; office, off-shore drilling, testing, and other equipment; transportation equipment that is not a structural component of a building; printing presses; refrigerators; individual air-conditioning units; grocery counters; furnishings of a motel, hotel, or office building; antennae; waveguides; transmitting, receiving, and multiplex equipment; prewired modular racks; display racks and shelves; gas pumps; and hydraulic car lifts.

Intangible assets that are real property

These proposed regulations also provide that certain intangible assets are real property for purposes of sections 856 through 859. To be real property, the intangible asset must derive its value from tangible real property and be

inseparable from the tangible real property from which the value is derived. Under §1.856-2(d)(3) the assets of a REIT are its gross assets determined in accordance with generally accepted accounting principles (GAAP). Intangibles established under GAAP when a taxpayer acquires tangible real property may meet the definition of real property intangibles. A license or permit solely for the use, occupancy, or enjoyment of tangible real property may also be an interest in real property because it is in the nature of an interest in real property (similar to a lease or easement). If an intangible asset produces, or contributes to the production of, income other than consideration for the use or occupancy of space, then the asset is not real property or an interest in real property. Thus, for example, a permit allowing a taxpayer to engage in or operate a particular business is not an interest in real property.

Other definitions of real property

The terms real property and personal property appear in numerous Code provisions that have diverse contexts and varying legislative purposes. In some cases, certain types of assets are specifically designated as real property or as personal property by statute, while in other cases the statute is silent as to the meaning of those terms. Ordinarily, under basic principles of statutory construction, the use of the same term in multiple Code provisions would imply (absent specific statutory modifications) that Congress intended the same meaning to apply to that term for each of the provisions in which it appears. In the case of the terms real property and personal property, however, both the regulatory process and decades of litigation have led to different definitions of these terms, in part because taxpayers have advocated for broader or narrower definitions in different contexts.

For example, in the depreciation and (prior) investment tax credit contexts, a broad definition of personal property (and a narrow definition of real property) is

ordinarily more favorable to taxpayers. A tangible asset may generally be depreciated faster if it is personal property than if it is considered real property, see section 168(c) and (g)(2)(C), and (prior) section 38 property primarily included tangible personal property and excluded a building and its structural components, see §1.48-1(c) and (d). During decades of controversy, taxpayers sought to broaden the meaning of tangible personal property and to narrow the meanings of building and structural component in efforts to qualify for the investment tax credit or for faster depreciation. That litigation resulted in courts adopting a relatively broad definition of tangible personal property (and correspondingly narrow definition of real property) for depreciation and investment tax credit purposes.

Similarly, in the context of the Foreign Investment in Real Property Tax Act (FIRPTA), codified at section 897 of the Code, a narrower definition of real property is generally more favorable to taxpayers. Enacted in 1980, FIRPTA is intended to subject foreign investors to the same U.S. tax treatment on gains from the disposition of interests in U.S. real property that applies to U.S. investors. Accordingly, foreign investors can more easily avoid U.S. tax to the extent that the definition of real property is narrow for FIRPTA purposes. As in the depreciation and investment credit contexts, this situation has led to vigorous debate over the appropriate characterization of certain types of assets (such as intangible assets) that may have characteristics associated with real property but do not fall within the traditional categories of buildings and structural components. See, for example, Advance Notice of Proposed Rulemaking, Infrastructure Improvements Under Section 897, published in the **Federal Register** (REG-130342-08, 73 FR 64901) on October 31, 2008 (noting that taxpayers may be taking the position that a governmental permit to operate a toll bridge or toll road is not a United States real property interest for purposes of

section 897 and stating that the IRS and the Treasury Department are of the view that such a permit may properly be characterized as a United States real property interest in certain circumstances). In the case of FIRPTA, however, Congress modified the definition of real property to include items of personal property that are associated with the use of real property. See section 897(c)(6)(B) (including as real property movable walls, furnishings, and other personal property associated with the use of the real property). Consequently, it is explicitly contemplated in section 897 that an item of property may be treated as a United States real property interest for FIRPTA purposes, notwithstanding that it is characterized as personal property for other purposes of the Code.

In the REIT context, taxpayers ordinarily benefit from a relatively broad definition of real property. Consequently, taxpayers have generally advocated in the REIT context for a more expansive definition of real property than applies in the depreciation, (prior) investment tax credit, and FIRPTA contexts. In drafting these regulations, the Treasury Department and the IRS have sought to balance the general principle that common terms used in different provisions should have common meanings with the particular policies underlying the REIT provisions. These proposed regulations define real property only for purposes of sections 856 through 859. The IRS and the Treasury Department request comments, however, on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled, whether through modifications to these proposed regulations or through modifications to the regulations under other Code provisions.

Proposed Effective Date

The IRS and the Treasury Department view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property. As such, these proposed

regulations are proposed to be effective for calendar quarters beginning after these proposed regulations are published as final regulations in the **Federal Register**. The IRS and the Treasury Department solicit comments regarding the proposed effective date.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of these proposed rules. All comments will be available for public inspection and copying at <http://www.regulations.gov>, or upon request.

A public hearing has been scheduled for September 18, 2014, at 10:00 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions,

visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Andrea M. Hoffenson and Julianne Allen, Office of Associate Chief Council (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.856-3, paragraph (d) is revised to read as follows:

§1.856-3 Definitions.

* * * * *

(d) Real property. See §1.856-10 for the definition of real property.

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Par. 3. Section 1.856-10 is added to read as follows:

§1.856-10 Definition of real property.

(a) In general. This section provides definitions for purposes of part II, subchapter M, chapter 1 of the Internal Revenue Code (Code). Paragraph (b) of this section defines real property, which includes land as defined under paragraph (c) of this section, and improvements to land as defined under paragraph (d) of this section. Improvements to land include inherently permanent structures as defined under paragraph (d)(2) of this section, and structural components of inherently permanent structures as defined under paragraph (d)(3) of this section. Paragraph (e) of this section provides rules for determining whether an item is a distinct asset for purposes of applying the definitions in paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section identifies intangible assets that are real property or interests in real property. Paragraph (g) of this section provides examples illustrating the rules of paragraphs (b) through (f) of this section.

(b) Real property. The term real property means land and improvements to land. Local law definitions are not controlling for purposes of determining the meaning of the term real property.

(c) Land. Land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land. The storage of severed or extracted natural products or deposits, such as crops,

water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property.

(d) Improvements to land--(1) In general. The term improvements to land means inherently permanent structures and their structural components.

(2) Inherently permanent structure--(i) In general. The term inherently permanent structure means any permanently affixed building or other structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent. A distinct asset that serves an active function, such as an item of machinery or equipment, is not a building or other inherently permanent structure.

(ii) Building--(A) In general. A building encloses a space within its walls and is covered by a roof.

(B) Types of buildings. Buildings include the following permanently affixed distinct assets: houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(iii) Other inherently permanent structures--(A) In general. Other inherently permanent structures serve a passive function, such as to contain, support, shelter, cover, or protect, and do not serve an active function such as to manufacture, create, produce, convert, or transport.

(B) Types of other inherently permanent structures. Other inherently permanent structures include the following permanently affixed distinct assets: microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks;

stationary wharves and docks; and outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

(iv) Facts and circumstances determination. If a distinct asset (within the meaning of paragraph (e) of this section) does not serve an active function as described in paragraph (d)(2)(iii)(A) of this section, and is not otherwise listed in paragraph (d)(2)(ii)(B) or (d)(2)(iii)(B) of this section or in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the determination of whether that asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner in which the distinct asset is affixed to real property;

(B) Whether the distinct asset is designed to be removed or to remain in place indefinitely;

(C) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(D) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and

(E) The time and expense required to move the distinct asset.

(3) Structural components--(i) In general. The term structural component means any distinct asset (within the meaning of paragraph (e) of this section) that is a constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with

electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. Structural components are real property only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related. If a distinct asset is customized in connection with the rental of space in or on an inherently permanent structure to which the asset relates, the customization does not affect whether the distinct asset is a structural component.

(ii) Types of structural components. Structural components include the following distinct assets and systems: wiring; plumbing systems; central heating and air conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

(iii) Facts and circumstances determination. If a distinct asset (within the meaning of paragraph (e) of this section) is not otherwise listed in paragraph (d)(3)(ii) of this section or in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the determination of whether the asset is a structural component is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner, time, and expense of installing and removing the distinct asset;

(B) Whether the distinct asset is designed to be moved;

(C) The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;

(D) Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;

(E) Whether the distinct asset serves the inherently permanent structure in its passive function;

(F) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;

(G) Whether the distinct asset is installed during construction of the inherently permanent structure;

(H) Whether the distinct asset will remain if the tenant vacates the premises; and

(I) Whether the owner of the real property is also the legal owner of the distinct asset.

(e) Distinct asset--(1) In general. A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.

(2) Facts and circumstances. The determination of whether a particular separately identifiable item of property is a distinct asset is based on all of the facts and circumstances. In particular, the following factors must be taken into account:

(i) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

(ii) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

(iii) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

(iv) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

(f) Intangible assets--(1) In general. If an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible asset is real property or an interest in real property.

(2) Licenses and permits. A license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property. A license or permit to engage in or operate a business generally is not real property or an interest in real property because it produces or contributes to the production of income other than consideration for the use or occupancy of space.

(g) Examples. The following examples demonstrate the rules of this section. Examples 1 and 2 illustrate the definition of land as provided in paragraph (c) of this section. Examples 3 through 10 illustrate the definition of improvements to land as provided in paragraph (d) of this section. Finally, Examples 11 through 13 illustrate whether certain intangible assets are real property or interests in real property as provided in paragraph (f) of this section.

Example 1. Natural products of land. A is a real estate investment trust (REIT). REIT A owns land with perennial fruit-bearing plants. REIT A leases the fruit-bearing plants to a tenant on a long-term triple net lease basis and grants the tenant an easement on the land. The unsevered plants are natural products of the land and qualify as land within the meaning of paragraph (c) of this section.

Fruit from the plants is harvested annually. Upon severance from the land, the harvested fruit ceases to qualify as land. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to qualify as real property.

Example 2. Water space superjacent to land. REIT B leases a marina from a governmental entity. The marina is comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. REIT B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land that qualify as land within the meaning of paragraph (c) of this section and, therefore, qualify as real property.

Example 3. Indoor sculpture. (i) REIT C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely. The sculpture does not manufacture, create, produce, convert, transport, or serve any similar active function.

(ii) When analyzed to determine whether it is an inherently permanent structure using the factors provided in paragraph (d)(2)(iv) of this section, the sculpture--

(A) Is permanently affixed to the building by supports embedded in the building's foundation;

(B) Is not designed to be removed and is designed to remain in place indefinitely;

(C) Would be damaged if removed and would damage the building to which it is affixed;

(D) Will remain affixed to the building after any tenant vacates the premises and will remain affixed to the building indefinitely; and

(E) Would require significant time and expense to move.

(iii) The factors described in this paragraph (g) Example 3 (ii)(A) through (ii)(E) all support the conclusion that the sculpture is an inherently permanent structure within the meaning of paragraph (d)(2) of this section and, therefore, is real property.

Example 4. Bus shelters. (i) REIT D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. REIT D enters into a long-term lease with a local transit authority for use of the bus shelters. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not significantly damage either the bus shelter or the real property to which it was affixed.

(ii) The bus shelters are not enclosed transportation stations or terminals and do not otherwise meet the definition of a building in paragraph (d)(2)(ii) of this section nor are they listed as types of other inherently permanent structures in paragraph (d)(2)(iii)(B) of this section.

(iii) When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the bus shelters--

(A) Are not permanently affixed to the land or an inherently permanent structure;

(B) Are designed to be removed and are not designed to remain in place indefinitely;

(C) Would not be damaged if removed and would not damage the sidewalks to which they are affixed;

(D) Will not remain affixed after the local transit authority vacates the site and will not remain affixed indefinitely; and

(E) Would not require significant time and expense to move.

(iv) The factors described in this paragraph (g) Example 4 (iii)(A) through (iii)(E) all support the conclusion that the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section. Although the bus shelters serve a passive function of sheltering, the bus shelters are not permanently affixed, which means the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property.

Example 5. Cold storage warehouse. (i) REIT E owns a refrigerated warehouse (Cold Storage Warehouse). REIT E enters into long-term triple net leases with tenants. The tenants use the Cold Storage Warehouse to store perishable products. Certain components and utility systems within the Cold Storage Warehouse have been customized to accommodate the tenants' need for refrigerated storage space. For example, the Cold Storage Warehouse has customized freezer walls and a central refrigeration system. Freezer walls within

the Cold Storage Warehouse are specifically designed to maintain the desired temperature within the warehouse. The freezer walls and central refrigeration system are each comprised of a series of interconnected assets that work together to serve a utility-like function within the Cold Storage Warehouse, were installed during construction of the building, and will remain in place when a tenant vacates the premises. The freezer walls and central refrigeration system were each designed to remain permanently in place.

(ii) Walls and central refrigeration systems are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of the freezer walls does not affect their qualification as structural components. Therefore, the freezer walls and central refrigeration system are structural components of REIT E's Cold Storage Warehouse.

Example 6. Data center. (i) REIT F owns a building that it leases to a tenant under a long-term triple net lease. Certain interior components and utility systems within the building have been customized to accommodate the particular requirements for housing computer servers. For example, to accommodate the computer servers, REIT F's building has been customized to provide a higher level of electrical power, central air conditioning, telecommunications access, and redundancies built into the systems that provide these utilities than is generally available to tenants of a conventional office building. In addition, the space for computer servers in REIT F's building is constructed on raised flooring, which is necessary to accommodate the electrical, telecommunications, and HVAC infrastructure required for the servers. The following systems of REIT F's building have been customized to permit the building to house the servers: central heating and air conditioning system, integrated security system, fire suppression system, humidity control system, electrical distribution and redundancy system (Electrical System), and telecommunication infrastructure system (each, a System). Each of these Systems is comprised of a series of interconnected assets that work together to serve a utility-like function within the building. The Systems were installed during construction of the building and will remain in place when the tenant vacates the premises. Each of the Systems was designed to remain permanently in place and was customized by enhancing the capacity of the System in connection with the rental of space within the building.

(ii) The central heating and air conditioning system, integrated security system, fire suppression system, and humidity control system are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of these Systems does not affect the qualification of these Systems as structural components of REIT F's building within the meaning of paragraph (d)(3) of this section.

(iii) In addition to wiring, which is listed as a structural component in paragraph (d)(3)(ii) of this section and, therefore, is real property, the Electrical System and telecommunication infrastructure system include equipment used to

ensure that the tenant is provided with uninterruptable, stable power and telecommunication services. When analyzed to determine whether they are structural components using the factors in paragraph (d)(3)(iii) of this section, the Electrical System and telecommunication infrastructure system--

(A) Are embedded within the walls and floors of the building and would be costly to remove;

(B) Are not designed to be moved, are designed specifically for the particular building of which they are a part, and are intended to remain permanently in place;

(C) Would not be significantly damaged upon removal and although they would damage the walls and floors in which they are embedded, they would not significantly damage the building if they were removed;

(D) Serve a utility-like function with respect to the building;

(E) Serve the building in its passive function of containing, sheltering and protecting computer servers;

(F) Produce income as consideration for the use or occupancy of space within the building;

(G) Were installed during construction of the building;

(H) Will remain in place when the tenant vacates the premises; and

(I) Are owned by REIT F, which also owns the building.

(iv) The factors described in this paragraph (g) Example 6 (iii)(A), (iii)(B), and (iii)(D) through (iii)(I) all support the conclusion that the Electrical System and telecommunication infrastructure system are structural components of REIT F's building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) Example 6 (iii)(C) would support a conclusion that the Electrical System and telecommunication infrastructure system are not structural components. However this factor does not outweigh the factors supporting the conclusion that the Electric System and telecommunication infrastructure system are structural components.

Example 7. Partitions. (i) REIT G owns an office building that it leases to tenants under long-term triple net leases. Partitions are used to delineate space between tenants and within each tenant's space. The office building has two types of interior, non-load-bearing drywall partition systems: a conventional drywall partition system (Conventional Partition System) and a modular drywall partition system (Modular Partition System). Neither the Conventional Partition

System nor the Modular Partition System was installed during construction of the office building. Conventional Partition Systems are comprised of fully integrated gypsum board partitions, studs, joint tape, and covering joint compound. Modular Partition Systems are comprised of assembled panels, studs, tracks, and exposed joints. Both the Conventional Partition System and the Modular Partition System reach from the floor to the ceiling.

(ii) Depending on the needs of a new tenant, the Conventional Partition System may remain in place when a tenant vacates the premises. The Conventional Partition System is designed and constructed to remain in areas not subject to reconfiguration or expansion. The Conventional Partition System can be removed only by demolition, and, once removed, neither the Conventional Partition System nor its components can be reused. Removal of the Conventional Partition System causes substantial damage to the Conventional Partition System itself but does not cause substantial damage to the building.

(iii) Modular Partition Systems are typically removed when a tenant vacates the premises. Modular Partition Systems are not designed or constructed to remain permanently in place. Modular Partition Systems are designed and constructed to be movable. Each Modular Partition System can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a Modular Partition System does not cause any substantial damage to the Modular Partition System itself or to the building. The Modular Partition System may be moved to accommodate the reconfigurations of the interior space within the office building for various tenants that occupy the building.

(iv) The Conventional Partition System is a wall, and walls are listed as structural components in paragraph (d)(3)(ii) of this section. The Conventional Partition System, therefore, is real property.

(v) When analyzed to determine whether it is a structural component using the factors provided in paragraph (d)(3)(iii) of this section, the Modular Partition System--

- (A) Is installed and removed quickly and with little expense;
- (B) Is not designed specifically for the particular building of which it is a part and is not intended to remain permanently in place;
- (C) Is not damaged, and the building is not damaged, upon its removal;
- (D) Does not serve a utility-like function with respect to the building;
- (E) Serves the building in its passive function of containing and protecting the tenants' assets;

(F) Produces income only as consideration for the use or occupancy of space within the building;

(G) Was not installed during construction of the building;

(H) Will not remain in place when a tenant vacates the premises; and

(I) Is owned by REIT G.

(vi) The factors described in this paragraph (g) Example 7 (v)(A) through (v)(D), (v)(G), and (v)(H) all support the conclusion that the Modular Partition System is not a structural component of REIT G's building within the meaning of paragraph (d)(3) of this section and, therefore, is not real property. The factors described in this paragraph (g) Example 7 (v)(E), (v)(F), and (v)(I) would support a conclusion that the Modular Partition System is a structural component. These factors, however, do not outweigh the factors supporting the conclusion that the Modular Partition System is not a structural component.

Example 8. Solar energy site. (i) REIT H owns a solar energy site, among the components of which are land, photovoltaic modules (PV Modules), mounts, and an exit wire. REIT H enters into a long-term triple net lease with a tenant for the solar energy site. The mounts (that is, the foundations and racks) support the PV Modules. The racks are affixed to the land through foundations made from poured concrete. The mounts will remain in place when the tenant vacates the solar energy site. The PV Modules convert solar photons into electric energy (electricity). The exit wire is buried underground, is connected to equipment that is in turn connected to the PV Modules, and transmits the electricity produced by the PV Modules to an electrical power grid, through which the electricity is distributed for sale to third parties.

(ii) REIT H's PV Modules, mounts, and exit wire are each separately identifiable items. Separation from a mount does not affect the ability of a PV Module to convert photons to electricity. Separation from the equipment to which it is attached does not affect the ability of the exit wire to transmit electricity to the electrical power grid. The types of PV Modules and exit wire that REIT H owns are each customarily sold or acquired as single units. Removal of the PV Modules from the mounts to which they relate does not damage the function of the mounts as support structures and removal is not costly. The PV Modules are commonly viewed as serving the useful function of converting photons to electricity, independent of the mounts. Disconnecting the exit wire from the equipment to which it is attached does not damage the function of that equipment, and the disconnection is not costly. The PV Modules, mounts, and exit wire are each distinct assets within the meaning of paragraph (e) of this section.

(iii) The land is real property as defined in paragraph (c) of this section.

(iv) The mounts are designed and constructed to remain permanently in place, and they have a passive function of supporting the PV Modules. When analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section, the mounts--

(A) Are permanently affixed to the land through the concrete foundations or molded concrete anchors (which are part of the mounts);

(B) Are not designed to be removed and are designed to remain in place indefinitely;

(C) Would be damaged if removed;

(D) Will remain affixed to the land after the tenant vacates the premises and will remain affixed to the land indefinitely; and

(E) Would require significant time and expense to move.

(v) The factors described in this paragraph (g) Example 8 (iv)(A) through (iv)(E) all support the conclusion that the mounts are inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are real property.

(vi) The PV Modules convert solar photons into electricity that is transmitted through an electrical power grid for sale to third parties. The conversion is an active function. The PV Modules are items of machinery or equipment and are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property. The PV Modules do not serve the mounts in their passive function of providing support; instead, the PV Modules produce electricity for sale to third parties, which is income other than consideration for the use or occupancy of space. The PV Modules are not structural components of REIT H's mounts within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

(vii) The exit wire is buried under the ground and transmits the electricity produced by the PV Modules to the electrical power grid. The exit wire was installed during construction of the solar energy site and is designed to remain permanently in place. The exit wire is inherently permanent and is a transmission line, which is listed as an inherently permanent structure in paragraph (d)(2)(iii)(B) of this section. Therefore, the exit wire is real property.

Example 9. Solar-powered building. (i) REIT I owns a solar energy site similar to that described in Example 8, except that REIT I's solar energy site assets (Solar Energy Site Assets) are mounted on land adjacent to an office building owned by REIT I. REIT I leases the office building and the solar energy

site to a single tenant. Although the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company, the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building. The Solar Energy Site Assets were designed and constructed specifically for the office building and are intended to remain permanently in place but were not installed during construction of the office building. The Solar Energy Site Assets will not be removed if the tenant vacates the premises.

(ii) With the exception of the occasional transfers of excess electricity to a utility company, the Solar Energy Site Assets serve the office building to which they are constituent, and, therefore, the Solar Energy Site Assets are analyzed to determine whether they are a structural component using the factors provided in paragraph (d)(3)(iii) of this section. The Solar Energy Site Assets--

- (A) Are expensive and time consuming to install and remove;
- (B) Are designed specifically for the particular office building for which they are a part and are intended to remain permanently in place;
- (C) Will not cause damage to the office building if removed (but the mounts would be damaged upon removal);
- (D) Serve a utility-like function with respect to the office building;
- (E) Serve the office building in its passive function of containing and protecting the tenants' assets;
- (F) Produce income from consideration for the use or occupancy of space within the office building;
- (G) Were installed after construction of the office building;
- (H) Will remain in place when the tenant vacates the premises; and
- (I) Are owned by REIT I (which is also the owner of the office building).

(iii) The factors described in this paragraph (g) Example 9 (ii)(A), (ii)(B), (ii)(C) (in part), (ii)(D) through (ii)(F), (ii)(H), and (ii)(I) all support the conclusion that the Solar Energy Site Assets are a structural component of REIT I's office building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factors described in this paragraph (g) Example 9 (ii)(C) (in part) and (ii)(G) would support a conclusion that the Solar Energy Site Assets are not a structural component, but these factors do not outweigh factors supporting the conclusion that the Solar Energy Site Assets are a structural component.

(iv) The result in this Example 9 would not change if, instead of the Solar Energy Site Assets, solar shingles were used as the roof of REIT I's office building. Solar shingles are roofing shingles like those commonly used for residential housing, except that they contain built-in PV modules. The solar shingle installation was specifically designed and constructed to serve only the needs of REIT I's office building, and the solar shingles were installed as a structural component to provide solar energy to REIT I's office building (although REIT I's tenant occasionally transfers excess electricity produced by the solar shingles to a utility company). The analysis of the application of the factors provided in paragraph (d)(3)(ii) of this section would be similar to the analysis of the application of the factors to the Solar Energy Site Assets in this paragraph (g) Example 9 (ii) and (iii).

Example 10. Pipeline transmission system. (i) REIT J owns an oil pipeline transmission system that contains and transports oil from producers and distributors of the oil to other distributors and end users. REIT J enters into a long-term, triple net lease with a tenant for the pipeline transmission system. The pipeline transmission system is comprised of underground pipelines, storage tanks, valves, vents, meters, and compressors. Although the pipeline transmission system serves an active function, transporting oil, a distinct asset within the system may nevertheless be an inherently permanent structure that does not itself perform an active function. Each of these distinct assets was installed during construction of the pipeline transmission system and will remain in place when a tenant vacates the pipeline transmission system. Each of these assets was designed to remain permanently in place.

(ii) The pipelines and storage tanks are inherently permanent and are listed as inherently permanent structures in paragraph (d)(2)(iii)(B) of this section. Therefore, the pipelines and storage tanks are real property.

(ii) Valves are placed at regular intervals along the pipeline to control oil flow and isolate sections of the pipeline in case there is need for a shut-down or maintenance of the pipeline. Vents equipped with vent valves are also installed in tanks and at regular intervals along the pipeline to relieve pressure in the tanks and pipeline. When analyzed to determine whether they are structural components using the factors set forth in paragraph (d)(3)(iii) of this section, the valves and vents--

(A) Are time consuming and expensive to install and remove from the tanks or pipeline;

(B) Are designed specifically for the particular tanks or pipeline for which they are a part and are intended to remain permanently in place;

(C) Will sustain damage and will damage the tanks or pipeline if removed;

(D) Do not serve a utility-like function with respect to the tanks or pipeline;

(E) Serve the tanks and pipeline in their passive function of containing tenants' oil;

(F) Produce income only from consideration for the use or occupancy of space within the tanks or pipeline;

(G) Were installed during construction of the tanks or pipeline;

(H) Will remain in place when a tenant vacates the premises; and

(I) Are owned by REIT J.

(iii) The factors described in this paragraph (g) Example 10 (ii)(A) through (ii)(C) and (ii)(E) through (ii)(I) support the conclusion that the vents and valves are structural components of REIT J's tanks or pipeline within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) Example 10 (ii)(D) would support a conclusion that the vents and valves are not structural components, but this factor does not outweigh the factors that support the conclusion that the vents and valves are structural components.

(iv) Meters are used to measure the oil passing into or out of the pipeline transmission system for purposes of determining the end users' consumption. Over long distances, pressure is lost due to friction in the pipeline transmission system. Compressors are required to add pressure to transport oil through the entirety of the pipeline. The meters and compressors do not serve the tanks or pipeline in their passive function of containing the tenants' oil, and are used in connection with the production of income from the sale and transportation of oil, rather than as consideration for the use or occupancy of space within the tanks or pipeline. The meters and compressors are not structural components within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

Example 11. Goodwill. REIT K acquires all of the stock of Corporation A, whose sole asset is an established hotel in a major metropolitan area. The hotel building is strategically located and is an historic structure viewed as a landmark. The hotel is well run by an independent contractor but the manner in which the hotel is operated does not differ significantly from the manner in which other city hotels are operated. Under GAAP, the amount allocated to Corporation A's hotel is limited to its depreciated replacement cost, and the difference between the amount paid for the stock of Corporation A and the depreciated replacement cost of the hotel is treated as goodwill attributable to the acquired hotel. This goodwill derives its value and is inseparable from Corporation A's hotel. If REIT K's acquisition of Corporation A had been a taxable asset acquisition rather than a stock acquisition, the goodwill would have been included in the tax basis of the

hotel for Federal income tax purposes, and would not have been separately amortizable. The goodwill is real property to REIT K when it acquires the stock of Corporation A.

Example 12. Land use permit. REIT L receives a special use permit from the government to place a cell tower on federal government land that abuts a federal highway. Governmental regulations provide that the permit is not a lease of the land, but is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate REIT L if the site is needed for a higher public purpose. REIT L leases space on the tower to various cell service providers. Each cell service provider installs its equipment on a designated space on REIT L's cell tower. The permit does not produce, or contribute to the production of, any income other than REIT L's receipt of payments from the cell service providers in consideration for their being allowed to use space on the tower. The permit is in the nature of a leasehold that allows REIT L to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property.

Example 13. License to operate a business. REIT M owns a building and receives a license from State to operate a casino in the building. The license applies only to REIT M's building and cannot be transferred to another location. REIT M's building is an inherently permanent structure under paragraph (d)(2)(i) of this section and, therefore, is real property. However, REIT M's license to operate a casino is not a right for the use, enjoyment, or occupation of REIT M's building, but is rather a license to engage in the business of operating a casino in the building. Therefore, the casino license is not real property.

(h) Effective/applicability date. The rules of this section apply for calendar quarters beginning on or before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

John Dalrymple,

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Deputy Commissioner for Services and Enforcement.

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